

UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF CALIFORNIA

In re
THE ADVANCE GROUP, INC.,
Debtor.

Case No. 91-55199-MM
Chapter 11

**MEMORANDUM DECISION RE
MOTIONS TO DISMISS DEFENDANTS'
COUNTERCLAIMS (FRCP 12(B)(6))**

INTRODUCTION

Before the Court are EIS' motions to dismiss the counterclaims of The Advance Group and the Alchimistis under FRCP 12(b)(6) on the basis that the Asset Purchase Agreement contains an integration clause that precludes the defendants from introducing parol evidence to vary the terms of the agreement and that the Alchimistis do not have standing to seek reformation of the agreement because they are not parties to the agreement. For the following reasons, the motions are denied.

FACTS

After extensive negotiations commencing in August 1991, the debtor and EIS reached the terms of a sale of substantially all of the debtor's assets for \$6.5 million to EIS in February 1992 and formally documented those terms in an Asset Purchase Agreement. During the period of negotiation, the parties exchanged several letters of intent setting forth proposed sales terms, and the Court entered a Sales Procedure Order on January 17, 1992. The Court approved the sale on February 20, 1992. Paragraph 10.06 of the agreement provides that the Asset Purchase Agreement and the

1 attached schedules constitute the entire agreement between the parties, superceding and cancelling
2 any prior agreements (the "Intergration Clause"). Paragraph 10.07 of the agreement provides that its
3 terms are to be governed by and construed under Georgia law (the "Choice of Law Provision").

4 At confirmation in August 1992, a question arose as to the ownership of a life insurance
5 policy with an original cash surrender value of \$145,000. The Alchemistis are designated as the
6 owners of the insurance policy. The debtor stipulated to withhold \$175,000 from plan distributions
7 pending resolution of this ownership issue. The Asset Purchase Agreement does not explicitly
8 include or exclude the insurance policy although the asset was dealt with during the negotiation
9 process. EIS filed its complaint on December 12, 1992 seeking declaratory judgment that the
10 insurance policy was among the assets that EIS purchased under the Asset Purchase Agreement.
11 Both The Advance Group and the Alchemistis filed their answers and counterclaims seeking
12 reformation of the agreement to reflect the true intention of the parties that the insurance policy be
13 excluded from the sale. The Alchemistis further assert that because they owned the policy, the estate
14 could not have transferred it to EIS by the Asset Purchase Agreement. They also seek attorneys' fees
15 against EIS under Rule 11 for filing the motion to dismiss.

16 17 DISCUSSION

18 A. Dismissal Under Rule 12(b)(6)

19 For a defendant to prevail on a motion to dismiss under Rule 12(b)(6), it must appear beyond
20 doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to
21 relief. Conley v. Gibson, 355 U.S. 41, 45-46 (1957). The purpose of a motion to dismiss under
22 FRCP 12(b)(6) is to test the formal sufficiency of the statement of the claim for relief. It is not a
23 procedure for resolving a contest about the facts or the merits of the case. 5A Wright & Miller,
24 Federal Practice and Procedure § 1356 (West 1990). A Rule 12(b)(6) motion allows a defendant to
25 challenge the legal sufficiency of a complaint without subjecting itself to discovery. Rutman Wine
26 Co. v. Ernest and Julio Gallo Winery, 829 F.2d 729 (9th Cir. 1987). In reviewing the sufficiency
27 of the complaint, the issue is not whether the plaintiff will ultimately prevail but whether the plaintiff
28 is entitled to offer evidence to support the claims asserted. Scheuer v. Rhodes, 416 U.S. 232, 236

(1974). Such a motion is viewed with disfavor and is rarely granted. Hall v. City of Santa Barbara, 833 F.2d 1270, 1274 (9th Cir. 1986), cert. denied, 485 U.S. 940 (1988). Only where the pleading under attack fails to meet the liberal requirement of Rule 8(a) for a short and plain statement of the claim showing that the pleader is entitled to relief would the pleading be subject to dismissal under Rule 12(b)(6). 5A Wright & Miller, Federal Practice and Procedure § 1356 (West 1990). The matters raised in the motions seek disposition on the substantive merits and factual issues in the case, which the Court declines to do on the pleadings, so dismissal under Rule 12(b)(6) would be inappropriate.

B. Standing of the Alchemists

1. Choice of Law

The Alchemists brought their counterclaims against EIS to establish and enforce their personal property rights in the life insurance policy. EIS asserts that the Alchemists are bound by the Choice of Law Provision in the Asset Purchase Agreement, but the Alchemists are not parties to that agreement and are not bound by the Choice of Law Provision. Unimart v. Superior Court for County of Los Angeles, 82 Cal. Rptr. 249, 253 (Cal. App. 1969)(Court held that where right of arbitration is a matter of contract, one who is not a party to the contract cannot be compelled to comply with an agreement that is not binding on it).

In a dispute over the validity of and the rights arising under a contract, the relevant contacts for the court to consider with respect to the applicable law are the place of negotiation and contracting, the place of performance, the location of the subject matter of the contract, and the domicile of the parties. Stonewall Surplus Lines Ins. Co. v. Johnson Controls, Inc., 17 Cal. Rptr. 2d 713, 718 (Cal. App. 1993); Rest. 2d Conflict of Laws § 188(2) (1971). The rights created under a life insurance contract are determined by the local law of the state where the insured is domiciled at the time of completing the insurance application unless some other state has a more significant relationship. Rest. 2d Conflict of Laws § 192 (1971); 1 Witkin, Summary of California Law, Contracts § 70 (9th ed. 1987). The subject policy was issued in California, premiums have been paid in California, and the beneficiaries under the policy reside in California, so California law will be applied.

**2. California Law Recognizes Rights of Third Parties to
Contract to Seek to Reform Contract**

Cal. Civ. Code § 3399 provides that any party aggrieved may seek reformation of a contract that, because of fraud or mistake, fails to truly express the intention of the parties. An aggrieved party need not be an original party to the contract. It includes one who has suffered prejudice or pecuniary loss. Orcutt v. Ferranini, 46 Cal. Rptr. 715, 721 (Cal. App. 1965). Under California law, the Alchemistis have standing to pursue their claims for reformation of the Asset Purchase Agreement.

**C. The Integration Clause in the Asset Purchase Agreement
Does Not Preclude Parol Evidence Where Reformation is Sought**

EIS has argued that the integration clause in the Asset Purchase Agreement is binding on both The Advance Group and the Alchemistis and that it precludes the introduction of parol evidence to vary the terms of the agreement. However, under either Georgia or California law, parol evidence is admissible to determine the intent of the parties in an action to reform a contract. Ga. Code § 23-2-21; Vann v. Williams, 165 Ga. App. 457 (Ga. App. 1983); Kingsberry Homes v. Findley, 242 Ga. 362 (1978); Cal. Civ. Code § 3401; Maier Brewing Co. v. Pacific Nat'l Fire Ins. Co., 33 Cal. Rptr. 67, 71-72 (Cal. App. 1967). Also, the intention of the parties may properly be regarded when through fraud, mistake or accident, a written contract fails to express the real intention of the parties. Cal. Civ. Code §§ 1640, 1647; Pacific Gas & Electric Co. v. G.W. Thomas Drayage & Rigging Co., 442 P.2d 641, 69 Cal. Rptr. 561 (1968).

D. Cross Motion by Alchimisti for Sanctions

Finally, sanctions are inappropriate where a pleading is filed with a reasonable basis. Rule 11 sanctions are an extraordinary remedy to be exercised with extreme caution. Conn v. Borjorquez, 967 F.2d 1418 (9th Cir. 1992).

CONCLUSION

The motions of EIS to dismiss the counterclaims filed by The Advance Group and the Alchemistis are denied. The cross motion by the Alchemistis for sanctions is also denied.